Institutional Investment Advisors Limited

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Briefing Note

UK & Dutch Prime RMBS: A Relative Haven in a New Credit Storm

RMBS & ABS 2011 Year to Date

19 September 2011

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Introduction

This briefing summarises the performance since January 2011 of Prime residential mortgage backed securities (Prime RMBS) and the Asset Backed Securities market in general, compared to corporate bonds.

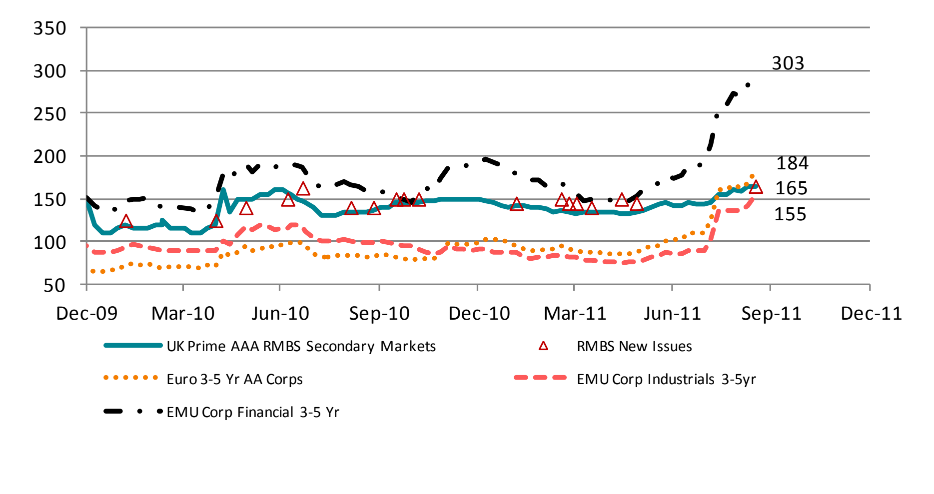
Summary

Prime AAA UK RMBS spreads have proved remarkably stable amid significant recent widening in credit generally and bank senior bonds in particular.

This sector continues to provide the best risk-adjusted value compared to the other low volatility senior secured sectors (Covered Bonds, Dutch RMBS and Auto ABS) and compared to non-financial AA corporate bonds.

We believe the current sell-off provides investors with a good opportunity to buy senior tranches of RMBS at very attractive levels.

Chart 1: UK Prime AAA RMBS versus Euro Corps – Spreads to EURIBOR – basis points



Source: JP Morgan, Bank of America Merrill Lynch, TwentyFour AM

- As **Chart 1** shows, since the end of May 2011 there has been a major widening in corporate bond spreads, due mainly to the poor performance of bank issues reflecting credit concerns linked to the Euro area sovereign debt crisis. However, industrial spreads also widened significantly in August and September.
- UK Prime AAA RMBS has proved much more stable than either senior bank or non-financial corporate bond debt so far this year.
- Covered bond ('CB') spreads (**Chart 3**) have proved more sensitive to relative bank issuer strength than RMBS issues. A recent Abbey 5 yr covered bond issue was priced at 150bps over LIBOR vs a Barclays 3 yr CB priced at 53 bps. But the differential between secondary market Prime RMBS from these two banks is only around 20 bps.
- Greater spread widening in (1) UK Buy to Let and Non Conforming RMBS and (2) junior tranches of prime RMBS underlines the market's "risk off" stance and preference for prime collateral and senior ranking.
- The technical conditions largely responsible for the underperformance of Prime AAA UK RMBS in late 2007 and 2008 are now absent as the forced sell off by leveraged investors has ended. In generally stressed conditions, we believe the recent lower volatility of this sector reflects its strong underlying credit fundamentals.

1. Prime RMBS versus Corporate Bonds

Back in January 2011, the following table showed the pick-up available on high quality RMBS versus returns on lower rated and less transparent corporate credits.

In the challenging conditions since August 2011, this pick up has gone but the quality distinction has not. While UK Prime AAA RMBS have held up well since January 2011, with spreads widening only some **15**bps by 15 Sep 2011, 3-5 year AA Corps have widened **83**bps from 101 bps to 184 bps.

Spreads versus LIBOR	Average 2005 to mid 2007	Crisis Peak	8 Jan 2010	6 Jan 2011	15 Sep 2011
UK Prime AAA RMBS (5Yr)	10 bps	420 bps	120 bps	150 bps	165 bps
3-5 year AA Euro Corps	9 bps	244 bps	65 bps	101 bps	184 bps

2. Prime UK RMBS versus Other ABS Sectors and Covered Bonds

Chart 2 compares AAA **senior** tranches of ABS against AAA Covered Bonds and AA Corporate Bonds.

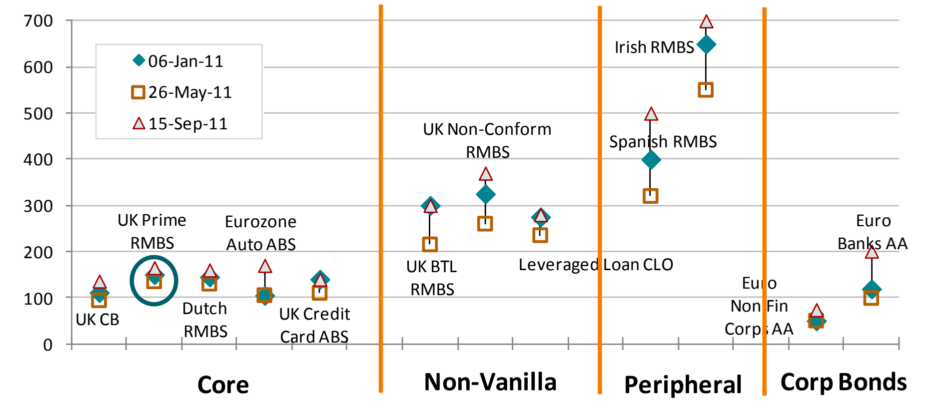
During 2011, UK Prime RMBS has so far proved one of the least volatile sectors along with UK CB, Dutch RMBS, Credit Cards and Euro Non Financial AA Corporates.

Among these lower volatility sectors, UK Prime RMBS is the largest and represents the best value.

Chart 3 compares recent Covered Bond issues with secondary senior RMBS spread levels of three UK banks. Note the strong impact of sponsor strength on CB pricing compared to its much diluted impact on RMBS. Abbey's Spanish parentage raises its relative CB spreads much more than its RMBS.

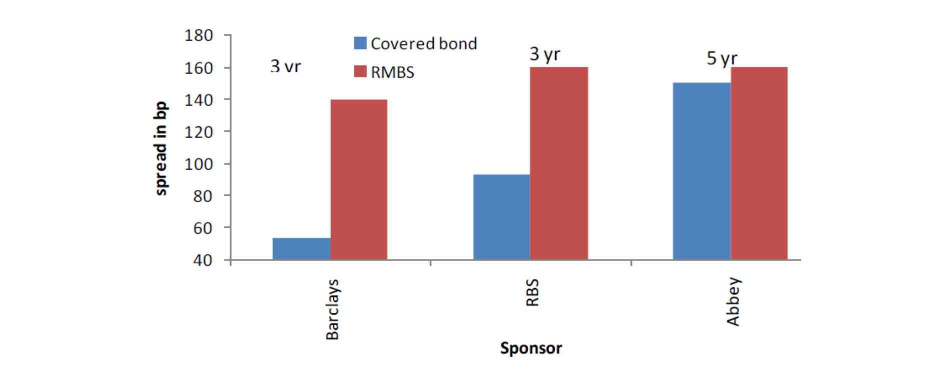
Junior tranches of UK RMBS have not been immune to the recent general widening in credit spreads. **Chart 4** shows that junior tranches of RMBS have proved significantly more volatile than senior during 2011 to date. In our view, this reflects a "risk off" investor stance, as the fundamental performance remains strong.

Chart 2: UK/Europe Senior ABS, Covered Bonds and Corporate Bonds Spreads by Sector in 2011 (basis points Vs LIBOR/Euribor)



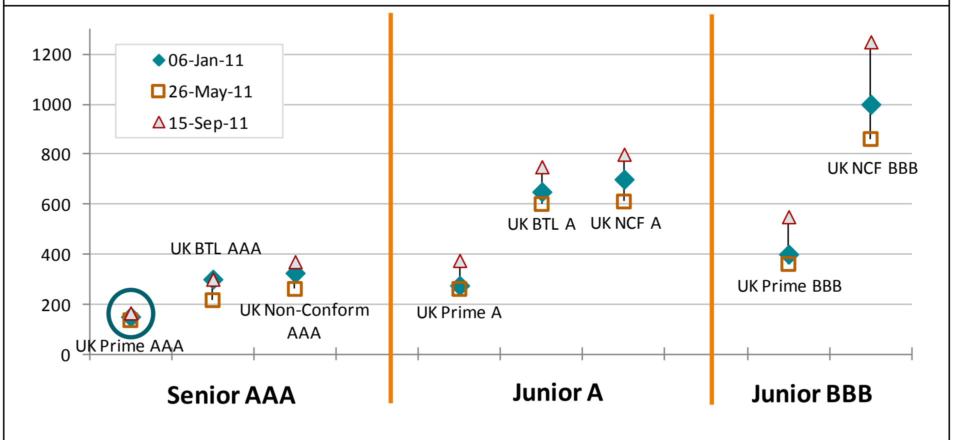
Source: Adjusted version of chart by Deutsche Bank, updated using BAML data. CB = Covered bonds, BTL = Buy to Let

Chart 3: UK Covered Bond Issues in Early September 2011 versus Secondary RMBS



Source: Deutsche Bank, 6 Sept 2011

Chart 4: UK RMBS Spreads, Senior & Mezzanine Tranches in 2011



Source: BAML data

3. Prime UK RMBS in 2007/08 and in the current crisis

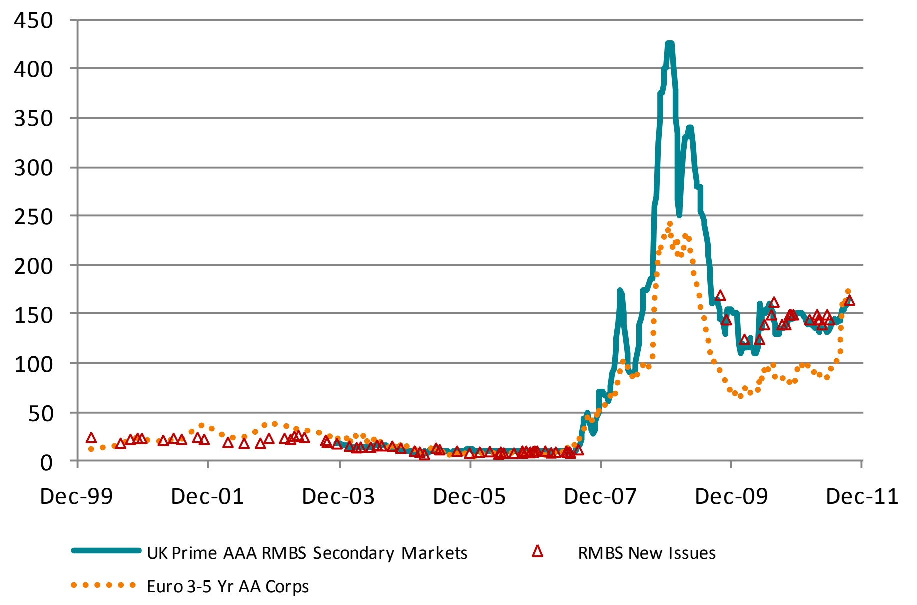
2007/08

The long period prior to the crisis of very low spreads on the highest quality ABS was largely due to the impact of the leveraged section of the buyer base and especially highly leveraged SIVs and ABCP conduits. (See **Chart 5** for RMBS).

This was particularly the case for floating rate issues since they could be financed readily via borrowing or repo on a floating rate basis without requiring a swap to extinguish interest rate risk.

During the first seven years of this century, the market was in effect overbought as regards an unleveraged investor who therefore did not buy this paper.

Chart 5: UK Prime AAA RMBS versus Euro Corps – Spreads to EURIBOR – basis points



Source: JP Morgan, Bank of America Merrill Lynch, 24AM

Meanwhile, 10bps to a 15X leveraged investor was worth 150bps gross.

When the crisis occurred, the SIVs and ABCP conduits were forced to liquidate when their funding ran dry or they were absorbed by their parent banks. The demise of the ABCP conduits alone is reflected in the fall in total USD and Euro outstandings for all ABCP borrowers from $ 1,400 billion equivalent in 2006 to around $400 billion in 2010 and at mid 2011.

During the 2007/08 crisis and at the extremes, the raw spread data in Chart 5 for RMBS reflected non-binding broker marks in the context of disrupted secondary market activity, the vast majority of which involved forced transactions many of which were not at arm's length. The overwhelming overhang of RMBS as the leveraged investors withdrew ensured that spreads reflected demand falling off a cliff rather than fundamental credit concerns.

Control is being re-established by central banks and regulators to ensure that the SIVs and ABCP conduits do not return. As a result, spreads for highest quality ABS – RMBS, Auto loans and Credit cards – have now settled at levels around 150bps, delivering a good return for a non-leveraged buyer. They are highly unlikely to revisit the previous narrow levels.

The Current Crisis

In the current crisis, the investor base for high quality ABS is much more stable. The SIVs and ABCP conduits have gone. Holders include many more unleveraged "real" money investors such as insurance companies and pension funds Concerns abound for both the asset (sovereign, corporate and retail lending) and liability (funding and capital) sides of bank balance sheets, raising bank senior debt spreads significantly. But senior Prime AAA RMBS and other high quality senior ABS spreads have widened only marginally. We believe this is an appropriate response to their strong credit fundamentals

4. UK Prime RMBS Credit Fundamentals

The Table below shows fundamental data for UK Prime RMBS Master Trusts from 3Q 2011.

With one exception (Granite), updated net loss rates are amply covered by "Excess spread" (net residual margin). In Granite's case, the net loss rate of 0.05% not covered by excess spread is extremely small and the high level of AAA credit enhancement is second only to Mound in the Trusts listed below.

UK Prime RMBS Master Trusts	Originator	£bn	Weighted Average LTV (indexed)	Net loss rate	Seller share	Excess spread	Credit enhancement:		
							AAA	**AA**	**A**
Arkle	Lloyds	24.83	65.51%	0.06%	50%	0.76%	21.90%	17.69%	15.62%
Fosse	Santander	18.20	61.02%	0.01%	14%	0.29%	17.93%	17.67%	17.46%
Gracechurch	Barclays	9.13	58.55%	0.01%	49%	0.41%	24.33%	21.40%	18.87%
Granite	Northern Rock	21.73	86.54%	0.38%	19%	0.33%	27.22%	20.23%	13.32%
Holmes	Santander	11.30	64.05%	0.05%	39%	1.24%	14.54%		
Lanark	Yorkshire and Clydesdale	2.07	57.83%	0.11%	14%	0.37%	12.44%		
Lothian	Barclays	1.74	59.76%	0.01%	76%	2.11%	12.68%	8.27%	4.96%
Mound	HBOS	8.47	69.23%	0.08%	29%	1.65%	41.30%	40.72%	39.64%
Permanent	HBOS	36.35	65.37%	0.04%	37%	0.68%	13.42%	12.71%	
Silverstone	Nationwide	31.42	59.70%	0.01%	34%	0.76%	13.81%		

Source: Master Trust reports and 24AM

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